HIGHLAND FINANCIAL
Partners, L.P.

January 27, 2009

Dear Investors,

This letter provides a periodic update for the limited partners of Highland Financial Partners, L.P. ("HFP" or "the Partnership"). The Partnership's largest limited partner is Highland Capital Management, L.P. ("HCMLP" or "Highland"). Highland is also an investment manager of other hedge funds and retail funds that operate as separate legal entities, independent of HFP. It is important to note that this letter applies only to HFP.

The past three months have been extremely challenging for HFP. During October, our adjusted book value decreased from \$5.78 to \$.07, and from \$.07 to \$0.00 during November, driven primarily by declining marks (unrealized losses) in our securities' portfolio. We expect our December 31, 2008 balance sheet will reflect liabilities greatly exceeding our assets. With the deteriorating condition of the credit markets overall and the global loss of liquidity in almost every market, we currently see no impetus for a reversal in the mark trends. In addition, as discussed in the second quarter financial statements that we recently distributed[1], HFP has begun to experience significant liquidity issues due to the continued deterioration of the credit markets and the economy as a whole.

The purpose of this letter is to provide a brief overview of the conditions in the leveraged loan and Collateralized Loan Obligation ("CLO")[2] markets and the effect they have had on HFP's recent operating performance.

A. Overview of the Leveraged Loan and CLO Markets

The global financial crisis has generated unprecedented volatility in the fixed income markets, with credit spreads at their highest levels in recent history. The anticipated increase of corporate loan default rates and the collapse of the structured credit market have driven prices on these asset classes to all time lows. The downward trends in the prices of leveraged loans and CLO securities that we are currently experiencing began in October 2007 and have accelerated rapidly over the past 90 days. In the fourth quarter of 2008, the average S&P LSTA Leveraged Loan Index[3] bid fell by approximately 25.1%, from 82.44[4] to 61.74[5] and is now comparable to the trading price of high yield bonds. By comparison, the fall in the average loan bid price from December 31, 2007 through September 30, 2008 was approximately 12.7%.

[1] A complete copy of the financial statements is available on our website www.hfplp.com.
[2] Collateralized loan obligations ("CLOs") are a form of securitization where payments from multiple loans are pooled together and passed on to different classes of owners in various tranches.
[3] The S&P/LSTA Leveraged Loan Index (LLI) is a leveraged loan index which covers the U.S. loan market. The index reflects the market-weighted performance of institutional leveraged loans in the U.S. loan market based upon real-time market weightings, spreads and interest payments. All of the index components are the institutional tranches (Term Loan A, Term Loan B and higher and Second Lien) of loans syndicated to U.S. loan investors. If a loan that consists of tranches is syndicated both in the U.S. and Europe (i.e., a cross-border transaction), the US dollar portion that is syndicated in the U.S. market is tracked by the LLI and the Euro portion that is syndicated in the European market is tracked by the ELLI. The LLI series currently calculates total return daily with an inception date of 1 January 1997. Total return is the product of two components: interest income return and market value return.
[4] As of September 30, 2008.

HIGHLAND FINANCIAL Partners, L.P.

The fall in loan prices has been driven primarily by an excess supply of loans due to the forced liquidation of total return swap facilities and hedge funds liquidating assets in order to meet margin calls and redemptions. This has been coupled with a decrease in demand due to the closure of the structured credit markets, including CLOs. Until the summer of 2007, growth in the leveraged loan market had been exploding, mainly driven by LBO activity and growth of the structured products market. In October 2008, the supply of leveraged loans increased as several banks, suffering their own liquidity issues, escalated the forced unwinds of financing facilities and credit exposure to hedge funds. Bids-Wanted-in-Competition ("BWIC")[6] totaled approximately $3.3 billion of par value compared to only $217 million in September[7]. Over 70% of new loans issued from 2003 to 2007 were purchased by CLOs. With primary CLO issuance at a standstill and the inability of CLOs to purchase such deep discounted assets, there was no demand for a significant portion of the assets flooding the market. In addition, retail funds, which generated approximately 29%[8] of the historical demand for leveraged loans, are now facing dramatically increased redemption requests from their investors, which are preventing them from purchasing additional loans and even forcing them to liquidate assets to meet such redemption requests.

Although the downward trend in loan prices has vastly exceeded the decline in the credit quality of the issuers, we have begun to see an increase in default rates in recent months. Loan defaults have risen sharply since bottoming in 2007 at a record low of 0.15%[9]. As of January 6, 2009, default rates for below investment grade corporate loans stood at 3.82% by issuer count and 4.76% by dollar volume[10]. While more loans have defaulted, the average value of these defaults has been relatively small in comparison to the average loan size (hence the gap between these measures). It should be noted that the average discount spread on loans of Libor + 1695[11] basis points is approximately 1391 basis points higher than the average historical spread of Libor + 304 basis points[12].

The fourth quarter of 2008 was also one of the worst for ratings downgrades on US leveraged loans. The number of issuers downgraded during the quarter was 119 according to the data tracked by the S&P/LSTA leveraged loan index. This was the largest number of downgrades in any quarter dating back to March of 2000. This is significant because ratings based tests that are in the later vintages of CLOs potentially cause the diversion of cash flows once the CCC rated assets rise above a certain threshold, typically 7.5%. Once CCCs are above this threshold, the excess CCCs are marked-to-market for purposes of the overcollateralization tests in the transaction. By the end of the year, the amount of loans in the

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[5] As of December 31, 2008.

[6] BWICs represent a process for auctioning loan portfolios whereby an intermediary sends a spreadsheet of the loans to potential buyers. The buyers usually have a couple of days to submit bids for the entire portfolio or portions of it

[7] Source: Standard & Poor's LCD.

[8] Source: Standard & Poor's LCD.

[9] Source: Standard & Poor's LCD, LCD Loan Stats Weekly 11/17/08.

[10] Source: Standard & Poor's LCD. Default rate by principal amount is calculated as the amount defaulted over the last twelve months divided by the amount outstanding at the beginning of the twelve-month period. Default rate by number of issuers is calculated as the number of defaults over the last twelve months divided by the number of issuers in the index at the beginning of the twelve-month period.

[11] Source: S&P LCD Secondary Spreads by Rating and Industry Report, October 31, 2008. Excludes facilities in default. Discounted spread assumes discount from par is amortized evenly over a three-year life.

[12] Historical risk premium is determined by subtracting an implied historical loss of 90 bps (3% average historical default rate and 30% average loss given default) from the historical average secondary spread of 394 bps (source: S&P LCD Secondary Spreads by Rating and Industry Report; October 31, 2008). Implied default rate is calculated as the difference between the current secondary spread and the historical risk premium and dividing that figure by an average loss given default of 30%.

HIGHLAND FINANCIAL Partners, L.P.

S&P/LSTA leveraged loan index with a rating of CCC+ or below was 12.3%, excluding non-rated loans. That same percentage was 5.24% as of September 19, 2008 and 3.7% as of June 30, 2008. The deterioration in the credit quality of loans has adversely impacted the Partnership's adjusted book value, as the allowance for loan losses increases to match the increase in expected future losses in the Partnership's portfolio of loans.

The increasing default rate and aggressive downgrade actions by the agencies on corporate bank loans have also affected our structured finance subsidiaries'[13] ability to satisfy certain collateralization tests and interest diversion tests. To the extent the subsidiaries fail to meet such collateral tests, all or a portion of the distributions payable to the Partnership and other equity holders are required to be invested in new eligible assets within the structured finance subsidiary or diverted to the debt holders until such failures are cured. During the fourth quarter, the cash flow diversion tests for two of the structured finance subsidiaries were triggered, which resulted in a reduction of equity flows to the Partnership of approximately $2,800,000. We anticipate that conditions in the credit markets will continue to weaken, and it is possible that actual defaults or credit-rating actions on the assets held will further impair, or very likely stop, the equity flows to the Partnership for some period of time. We are actively monitoring the credit quality of all positions in the underlying portfolios.

The dislocation in the leveraged loan market is even more pronounced in the market for CLO securities, which represent the structured product equivalent of the loan asset class. Approximately 12% of our $14.8 billion in assets are CLO securities. Spreads on CLO tranches have widened to historic levels (Refer to Appendix B). As a result, the weighted average mark on CLO securities that we record on our balance sheet at fair value[14] fell by approximately 28% in October (more than double the amount of the decline in loan prices) and approximately 14% in November, compared to a 15.6% decline during the entire third quarter. Only after we began to receive broker quotes during the first week of November did the magnitude of the market-to-market losses become known. We believe this asset class was subject to the same forced selling pressure as their underlying loans, but in a much higher magnitude. The unrealized losses that we recorded on our securities portfolio during November, coupled with the increase in our reserve for loan losses, was of enough magnitude to reduce our book value to zero as of November 30.

During the month of December, CLO security prices deteriorated further, and by the end of the month, virtually all A, BBB, BB and equity tranches were trading below fifteen cents on the dollar and most equity tranches were below ten cents on the dollar. (Refer to Appendix C.)

B. Short-Term Financing Arrangements

Exacerbating this rapid deterioration in market levels of our assets has been the unwillingness or inability of financing counter parties to provide term financing facilities, which are summarized below.

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[13] The term structured finance subsidiary refers to a majority-controlled entity of the Partnership that has issued long-term notes collateralized by CLO securities and leveraged loans.

[14] HFP estimates the fair value of the CLO securities held by its structured finance subsidiaries in accordance with the provisions of Statement of Financial Accounting Standards ("SFAS") No, 157. Please refer to footnote 3 of our March 31, 2008 financial statements for a definition of fair value. In addition, footnote 6 of those financial statements discusses the valuation techniques that HFP applies to its CLO securities.

HIGHLAND FINANCIAL Partners, L.P.

Secured Credit Facility

As discussed in notes 12 and 14 of our 2007 audited financial statements[1], we have historically relied on a secured credit facility to provide long-term liquidity for HFP to fund some of our strategic initiatives. The borrowings under the facility were secured by the equity interests in our structured finance subsidiaries. As the value of those interests declined in response to the market conditions discussed above (refer to Appendix C), the counterparty to the facility required us to post more cash collateral.

In March 2008, we re-negotiated the terms of the facility to free up almost $120 million of the cash collateral and we reduced the amount of our outstanding borrowings by approximately $67 million (leaving a total amount borrowed of approximately $166 million). At the time, we were optimistic that these new terms would provide us with sufficient access to the capital we needed to sustain our long-term business plan and significantly reduce the collateral we would be required to post in the future. However, due to the unexpected acceleration of the deterioration of market conditions in October, we received a collateral call from the counterparty for approximately $64 million. The previous margin calls for the months of August and September were $21 million and $29 million, respectively. A majority of the cash needed to meet the margin calls in October and November was raised from HCMLP and its affiliates (these parties are no longer able to provide funding to us prospectively). As a result, the Partnership was able to repay this market sensitive facility. If the Partnership had been unable to raise the cash to pay the margin calls, the counterparty would have exercised its rights under the facility and seized the underlying collateral and liquidated it at depressed prices to satisfy the margin calls.

Warehouse Facilities

As of September, 30, 2008, we had one remaining outstanding loan warehouse facility[15], which held a portfolio of European leveraged loans. This warehouse facility was scheduled to expire on January 31, 2009. However, in October 2008, the counterparty unexpectedly and unilaterally terminated the facility. Although we have not received final details, the counterparty claims to have liquidated the portfolio in November at levels which may result in over $100 million of realized losses for the Partnership. Approximately $56 million of collateral was previously posted, and the counterparty is holding it as an offset. Because we had previously expected to hold the assets to maturity, we recorded them on our balance sheet at amortized cost. Therefore, the decline in the assets' market value did not affect our operating performance or adjusted book value until they were seized by the counterparty. We have recognized the full amount of the potential loss in our financial statements and reserved our rights in this matter.

CLO Financing Facility

A wholly-owned subsidiary of HFP, Highland Special Opportunities Holding Company ("SOHC"), holds a 49% interest in a risk sharing agreement that holds CLO bonds and credit default swaps ("CDS") that reference CLO obligations (Refer to note 8 of the 2007 audited financial statements). During the fourth quarter of 2008, the market value of the assets underlying the risk sharing agreement was marked down by our financing counterparties by approximately 87%. The net result was an additional decrease in HFP's book value of approximately $249 million, or $4.98 per unit.

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[15] A "loan warehouse facility" is an agreement with a financial institution to finance the purchase of leveraged loans for the anticipated issuance of debt and equity when it converts into a structured finance subsidiary.

HIGHLAND FINANCIAL
Partners, L.P.

On November 6, 2008, SOHC received a request from the counterparty to post additional collateral in accordance with the terms of the agreement. Based on SOHC's inability to do so, the counterparty elected to terminate the agreement as of December 5, 2008. The counterparty has since notified SOHC that its pro-rata share of the losses incurred through the termination date was approximately $365 million and sent a formal demand for payment. SOHC is currently assessing all options with the counterparty to determine the final settlement of the facility.

C. Conclusion and Going Concern Considerations

It is currently clear that the future quarterly cash flows received by the Partnership will be dramatically reduced by the diversion of cash flows in our structured finance subsidiaries caused by the aggressive downgrade actions in the leveraged loan sector, coupled with increasing default rates.

Due to events and circumstances described in this letter, we have concluded as of December 31, 2008, it is likely that all future inflows of cash to HFP will be used to pay creditors and that there is no prospect of return to holders of HFP units. As such, the value of HFP units has suffered a permanent impairment. It should be noted that HCMLP and its employees have participated materially in every capital raise by HFP and also been adversely affected by these events. Net of base management fees received in prior periods, HCMLP and its employees have lost approximately $121 million that they invested in HFP.

D. Management Fees

Due to the unprecedented and unexpected downturn in economic conditions, the freefall in marks on our assets and the resulting negative impact on HFP, management has elected to permanently forgo any management fees that would be owed under the terms of the existing management agreement beginning in the fourth quarter of 2008.

Sincerely,

The Management Team
Highland Financial Partners, LP

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Attachments

Appendix A – Market Implied Default Rates
Appendix B – Widening Spreads on CLO Tranches
Appendix C – Pricing Trends of A, BBB, BB and Equity CLO Tranches
Appendix D – Summary of Operations, Third Quarter 2008
Appendix E – HFP Adjusted Book Value per Common LP Unit, November 2008

Cautionary Statement

This letter contains forward-looking statements. Forward-looking statements are based on management's current expectations that are subject to risks and uncertainties. We caution you that actual results may differ, perhaps materially, from the forward-looking statements included in this letter. We do not undertake to update any forward-looking statements.

Past performance does not guarantee future results. Performance during time period shown is limited and may not reflect the performance in different economic and market cycles. There can be no assurance that similar performance will be experienced. This material is for informational purposes only and does not constitute an offer to sell or solicitation of an offer to buy any securities or investment services. Investments in loan markets involve the risk of loss.

Targeted IRR described herein have been prepared by Highland Capital Management, L.P. on the basis of estimates and assumptions about the performance of the life settlement assets gross of fees and any expenses. Actual results may differ materially from these estimates. Targeted returns should not be relied upon as facts as there is no assurance that these results will be achieved.

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